

# REVIEW OF THE OUTLAY PAYMENT AND ESCROW RELEASE PROCESSES

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*Project # 20130601*



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# PROJECT SUMMARY

## Overview

Overall, Texas Water Development Board's (TWDB's) outlay payment and escrow release processes provide reasonable assurance that compliance with state law, TWDB rules and relevant contract requirements is achieved and that assets are safeguarded. TWDB has developed formal guidelines and written procedures aimed at ensuring outlay payments and escrow releases are properly and promptly processed, documented and approved in compliance with relevant laws, policies and procedures. The review found opportunities for improvement in the way escrows are administered. In fiscal year 2012, TWDB processed 1,848 outlay payments totaling \$565 million and 452 escrow releases totaling \$505 million.

Both the outlay payment and escrow release processes are shared between Contract Administration, Project Engineering and Review, and Accounting, which provides the Agency better opportunities for segregation of incompatible duties. These processes also ensure compliance with the agreed-upon quality assurance and sign-off procedures and other key requirements for each program.

Management indicated recent process improvements have enhanced consistency across programs and enhanced communication with both internal and external stakeholders.

## Summary of Management's Response

Management appreciates Internal Audit's acknowledgement that the outlay payment and escrow release processes provide reasonable assurance for compliance with requirements. Management also appreciates Internal Audit's suggestions for improvement and is working to implement the recommendations provided in this report. Detailed responses are described in each of the following sections.

## Scope

The audit focused on the outlay payment and escrow release processes and related transactions from loan closing through the life of the construction project, and primarily on activities from September 1, 2011, to August 31, 2012. Fieldwork was conducted during December, 2012.

# OBSERVATIONS, RECOMMENDATIONS, AND RESPONSES

## 1. Escrow Release Communications

There are opportunities for improvement in the way the Agency receives and communicates escrow release authorizations and other related information with external parties. For example, escrow release authorizations are communicated via email, facsimile and hard copy and do not include non-repudiation controls. Depending on the type of information being transmitted, the TWDB may be unnecessarily exposed to a variety of risks, such as later claims by an author of not having authored a particular document or a signatory of not having signed a document. More secure communication methods would improve authenticity and reduce the risk of unauthorized communications or alterations.

Authentication methods, such as Public Key Infrastructure (PKI), help provide more secure communication with external parties. In particular, for outlay payment and escrow releases, stronger non-repudiation controls may be warranted. Non-repudiation is similar to using a notary. It guarantees that the sender of a message cannot later deny having sent the message and that the recipient cannot deny having received the message. PKI is based on public key cryptography that uses a pair of related cryptographic keys to verify the identity of the sender (signing) and / or to ensure privacy (encryption).

## Recommendation

Management should consider enhancing security of electronically transmitted documents and other communication with intermediaries and third parties by implementing non-repudiation controls that aim to ensure:

- The sending party is genuine;
- The document was executed and sent at a particular time;
- The document was received at a particular time;
- The document was not disclosed to an unauthorized party during the course of transmission; and
- The document was not altered by an unauthorized party during the course of transmission.

Ideally, such non-repudiation controls should be implemented on all communications considered to be sensitive.

## Management Response

It is important to note that escrow release authorizations do not generate a financial transaction in TWDB's accounting systems. They authorize a release of funds from the financial assistance recipient's escrow account and result in a deposit to its construction account. Such transactions are performed by the financial assistance recipient and its escrow agent. TWDB's responsibilities are limited to release authorization. Management agrees that the auditor's recommendation of an electronically-transmitted, non-repudiation method of correspondence may be a useful enhancement in mitigating possible authentication risks and will evaluate the feasibility of implementing the auditor's recommendation.

**Target Implementation Date: August 2013**

## 2. Escrow Release Authorizations

### Observation

Escrow release authorizations could be enhanced to include confirmation of such information as previous release and released-to-date amounts. Such information would provide both the borrower and escrow agent with a red flag, should their records indicate differently.

### Recommendation

As part of the escrow release authorization communication, management should consider enhancing communication documents regarding escrow releases by providing more contextual information.

## Management Response

Management will evaluate enhancements to the format of the escrow release correspondence to include the TWDB escrow balances.

**Target Implementation Date: June 2013**

### 3. Uninterrupted Time Off

#### Observation

Current financial procedures do not require key staff to be absent from their duties for a minimum uninterrupted period of time while their duties and responsibilities are assumed by other employees. The TWDB processes large and complex financial transactions, and the absence of such a requirement increases the risk of any impropriety and/or record manipulation remaining undetected. Such practice would also benefit the Agency's overall training program.

Since not all positions offer opportunities to create material financial errors, the requirement could be applied based on an internal risk assessment. For example, the duration of time off could be adjusted based on the perceived risk. It is important to note that for this practice to be effective as a fraud deterrent and detection tool, someone else must perform the work during the time off.

If such a requirement is considered non-feasible, a strictly enforced and documented rotation of personnel might be considered a reasonable compensating control.

#### Recommendation

Financial management should consider enhancing the financial control environment by either implementing a practice that ensures key staff takes uninterrupted time off or requiring a strictly enforced rotation of duties in the positions or roles that are considered most vulnerable to material financial error or fraud.

Reevaluate the effectiveness of this control periodically.

#### Management Response

It is important to note that management currently has a number of controls in place to mitigate this risk as follows:

(i) All expenditure transactions require the approval of multiple employees; must be supported by budget approvals, purchase orders, and receiving reports; and require the approval of a general ledger accountant.

(ii) Loan closing transactions must be supported by local bond ordinances and require valid CUSIPS (i.e., security identification number issued by the Committee on Uniform Security

Identification Procedures) registered with the Depository Trust Corporation, approved by the state's Attorney General and registered with the State Comptroller.

(iii) All cash disbursements are managed by the State Comptroller.

(iv) Staff responsibilities are rotated as needed due to changing workloads as well as vacation or other leave needs.

(v) All treasury and trust accounts are reconciled and reviewed monthly.

Management will continue the practice of rotating staff responsibilities in the positions or roles that are considered most vulnerable.

## **4. User Access Reviews**

### **Observation**

One user access review and two appropriateness reviews for two key financial information systems were not documented. The Agency's IT Security Policy 2.1 requires access reviews to be documented.

An access review is conducted to ensure that the persons who have access to an application are still active employees and/or are still entitled to have access. An appropriateness review is conducted to ensure that an individual's level of access or privileges within an application is still appropriate, based on his or her role or responsibility.

### **Recommendation**

Financial management should ensure that all access reviews are performed, approved, and retained according to Agency standards. Business areas should work closely with IT to ensure compliance with standards.

### **Management Response**

Access and appropriateness reviews of Sage MIP Fund Accounting and ASAP are performed concurrently with semiannual reviews of Comptroller systems and will be documented in the future.

**Target Implementation Date: March 2013**

## BASIS OF REVIEW

### Objective & Scope

The objective of this review was to determine the extent to which TWDB's management of outlay payments and escrow releases provides assurance that strategic and operational results and outcomes are achieved in an efficient and effective manner and that payments are properly processed, documented and approved in compliance with relevant laws, policies and procedures.

### Criteria

Our audit was based upon standards as set forth in the Texas Administrative Code, TWDB's rules and other sound administrative practices. The audit was performed in compliance with the Institute of Internal Auditors' "International Standards for Professional Practice of Internal Auditing."

Additionally, we conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

### Background

Outlays are charges made to a construction project. Outlay reports are the required signed and certified documentation showing expenses incurred on a project commitment submitted by the financial assistance recipient to TWDB on a monthly/quarterly basis throughout the life of the project. The outlay report is also the mechanism used to request disbursements for installment-based programs and/or an escrow release for escrow-based programs where outlays are required for a release of funds. An escrow account is an account held by a borrower at an official state depository institution to hold loan proceeds in accordance with an escrow agreement until the Agency releases the funds. In fiscal year 2012, TWDB processed 1,848 outlay payments totaling \$565 million and 453 escrow releases totaling \$505 million.

Both the outlay and escrow release processes are shared between Contract Administration, Project Engineering and Review, and Accounting, as detailed in the following table.



Overview of Outlay and Escrow Release Roles			
	Construction Assistance	Contract Administration	Finance / Accounting
Receive and process documentation		x	
Review and approve funding request based on the progress of the project and submitted documentation	x		
Review package for approvals, completeness and accuracy based on prepared checklists		x	
Update internal record keeping		x	
Authorize transfer of federal funds to state accounts			x
Record accounting entry			
Authorize disbursement to local entity or entity's escrow account			x
Record accounting entry			
Authorize release of escrow funds to local entity		x	
Scan and file documents		x	x

## AUDIT TEAM INFORMATION

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